

Central Intelligence Agency

Washington, D. C. 20505

CIA | EA | 87-20023 Mnow
NOT
verification

DIRECTORATE OF INTELLIGENCE

10 February 1987

Japanese Imports: Sluggish Response to Yen Appreciation []

25X1

Summary

The 60-percent appreciation of the yen relative to the US dollar over the past two years is generating only a modest increase in Japanese imports. We believe that a more significant increase requires an upturn in Japan's economic growth. Although Japan's complex distribution system and the role of oil and gold imports complicate analysis of the import picture, a comparison of the last period of yen appreciation in 1977-78 with the present one buttresses this judgment. Even if the economy rebounds later this year--and without further yen appreciation we believe it will--the outlook for US exporters is not bright. Rather, the changing economic relationship between Japan and other East Asian countries will probably make them the primary beneficiaries of any increase in Japanese imports. []

25X1

This memorandum was prepared by [] Office of East Asian Analysis. Information available as of 10 February 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, []

25X1

25X1

EA M 87-20023

25X1

25X1

8

1/25X1

25X1

The Import Response to Date

Although total Japanese imports fell 2.3 percent--or \$2 billion--last year, we believe this is not an accurate indicator of the response of imports to the yen appreciation. On the one hand, we estimate that Japanese oil imports plummeted by \$17 billion last year because of falling prices--suggesting that the value of total imports understates the response of imports to the yen appreciation. On the other hand, the import total reflects an \$8 billion purchase of gold--\$6 billion higher than usual--that was used to mint coins to commemorate the 60th anniversary of the emperor's reign. Without these items, the dollar value of imports increased 13 percent during the first 10 months of 1986--a slightly brisker pace than the concurrent rise in import volume (see figures 1 and 2). [REDACTED]

25X1

In addition, analyzing only the total value of imports masks the variation in the response among different products. In contrast to the lackluster increase in industrial raw materials, consumer imports--such as fish, fruit, leather goods, knitted goods, and furniture--rose sharply. Moreover, according to a variety of press reports, Japanese consumers are responding to the advantages of a strong yen by purchasing imports by mail order from overseas manufacturers, a small but promising trend. [REDACTED]

25X1

The strong showing of consumer products probably accounts for most of the huge increase in imports from the Asian NICs--particularly Hong Kong, Taiwan, and South Korea--as well as from the European Community. During the first 10 months of 1986, imports from these countries increased an average of 45 percent. Besides being the source of inexpensive consumer products, the NICs have benefited because their currencies are tied to the US dollar and thus have weakened against the yen. In contrast, nonfuel, nongold Japanese imports from the United States--long concentrated in raw materials and capital goods--were virtually unchanged during the first 10 months of 1986. [REDACTED]

25X1

The Japanese Distribution System: Flies in the Ointment

Imports have not been more responsive to the yen appreciation partially because the stronger yen has not automatically translated into lower retail prices for foreign goods. Prices paid by Japanese importers have fallen by 25 percent over the last year, but a recent study by the Economic Planning Agency concluded that only half of the price decline had been passed to consumers by the end of 1986 (see figure 3). Our survey of nine consumer items shows that drops at the retail level ranged from only zero to 16 percent (see table 1), and other surveys, including two by the Japanese Government, show a similar reluctance by wholesalers to pass on exchange rate - related savings. [REDACTED]

25X1

We believe that much of the blame for the slowness of retail prices to adjust to the drop in import prices rests with Japan's highly inefficient distribution system (see table 2). Although there are differences among individual products, the Japanese distribution system for imported consumer goods is essentially a five-tiered arrangement: a product must pass through an importer, major distributor, regional

25X1

25X1

distributor, wholesaler, and retailer before it reaches the customer. This suggests that several decisions to reduce prices must be made before consumers see the positive effects of the high yen. In addition, because each level of the distribution chain--which ordinarily marks up foreign products by 2 to 5 percent--probably saw the yen appreciation as an opportunity to raise profits, the final price cut to the consumer is much less than the original appreciation. [REDACTED]

25X1

Sluggish Growth as the Main Culprit

Despite the effects of the distribution system, we believe that slow growth in Japan is primarily responsible for holding down the increase in imports--a judgment that we think is made clear by comparing the current yen appreciation with the last one in 1977-78.* Japanese Government statistics indicate that import volume increased approximately the same amount in the two periods. But this result is surprising because the 1985-86 appreciation was much larger than the 1977-78 appreciation; the yen has appreciated 60 percent since mid-1985, compared with only a 40-percent appreciation during the 1977-78.¹ [REDACTED]

25X1

The contrast is even more striking because of structural changes in the Japanese economy that should have made import demand more responsive to appreciation-induced changes in prices. Among Japanese imports, the share accounted for by raw materials and fuels--commodities that are basically insensitive to changes in price--has declined, while the share of intermediate goods--items that are more "price sensitive"--has increased. A 1984 Bank of Japan study also asserted that manufactured imports have become increasingly responsive to changes in price in recent years. We have not been able to verify the BOJ's claim, but it is plausible in light of the numerous trade packages negotiated with other governments over the last several years that have opened the Japanese market somewhat--a circumstance that in theory should lead to additional price competition. [REDACTED]

25X1

As such, we believe differences in economic growth between the two periods is the only factor to explain the dissimilar response of imports to the two appreciations. Real GNP growth during the recent appreciation is nearly 2.5 times slower than during the 1977-78 round of yen strengthening, which in turn has held down imports. In our judgment, this divergence in growth rates can be traced to two factors:

¹ The length of the periods of yen appreciation is nearly identical--five quarters--making a comparison relatively easy. [REDACTED]

25X1

25X1

25X1

- Tokyo's tight fiscal policy. Government spending is contributing virtually nothing to Japan's growth this year. This contrasts with the stimulative fiscal policy pursued by Prime Minister Fukuda's government during the 1977-78 appreciation.
- An export-dependent economy. Exports account for nearly 20 percent of Japan's GNP, compared with only 14 percent in 1977. As a result, the recent yen appreciation--by reducing exports--has had a stronger negative effect on economic growth.

25X1

To gauge the impact of slow growth on imports, we ran several econometric simulations using our model of the Japanese economy. We assumed that economic growth during the recent appreciation followed the same pattern as in the 1977-78 period--when growth continued at 5 percent a year--rather than the sharp decline that has occurred over the past several quarters. We raised GNP growth by alternately increasing the components of domestic demand--government spending, private consumption, government investment, or private investment. Our simulations show that import volume would now be 5 to 10 percent higher--\$6-14 billion in value--if growth had not slowed, with the trade impact greatest when private investment provided the stimulus.

25X1

Looking Ahead

The importance of growth suggests that nonfuel imports will increase further if the economy rebounds later this year--a likely prospect unless the yen continues to appreciate. We estimate that with an expanding economy total imports this year could be \$15-20 billion higher than in 1986, leading to a significant reduction in last year's record \$86 billion current account surplus. US exporters, however, probably will be able to garner only about \$2 billion of this increase. If we are correct in assuming that economic growth will be led by consumer spending, then the NICs will continue to be the major beneficiaries of Japan's increased imports. This suggests that Japan's overall trade surplus will shrink much faster than the bilateral surplus with the United States.²

25X1

Moreover, changes occurring in the economic relationship between Japan and other East Asian countries will probably make it even more difficult for US manufacturing firms to compete in the Japanese market. We expect that Japanese firms will increasingly invest in production facilities in the Asian NICs as well as other East Asian countries, including China. In contrast to Japanese production in the United States--which is geared almost entirely to sales in the US market--production in other East Asian countries will increasingly come back to Japan as imports for either sale in the Japanese domestic market or assembly prior to export.

25X1

25X1

² The dollar value of Japanese exports will probably decline slowly this year, with the fall likely spread fairly evenly over Japan's export markets.

25X1

25X1



25X1



25X1

25X1



25X1



25X1

Table 1

Japan. Retail Prices of Selected Imports
(percent change August 1985-August 1986)

| <u>Product</u> | <u>Price Change</u> |
|----------------|---------------------|
| Shrimp | -15.7 |
| Chocolate | -14.1 |
| Biscuits | -12.5 |
| Mutton | -6.7 |
| Whiskey | -6.0 |
| Cheese | -5.9 |
| Jam | -4.0 |
| Fountain Pens | 0 |
| Watches | 0 |



25X1

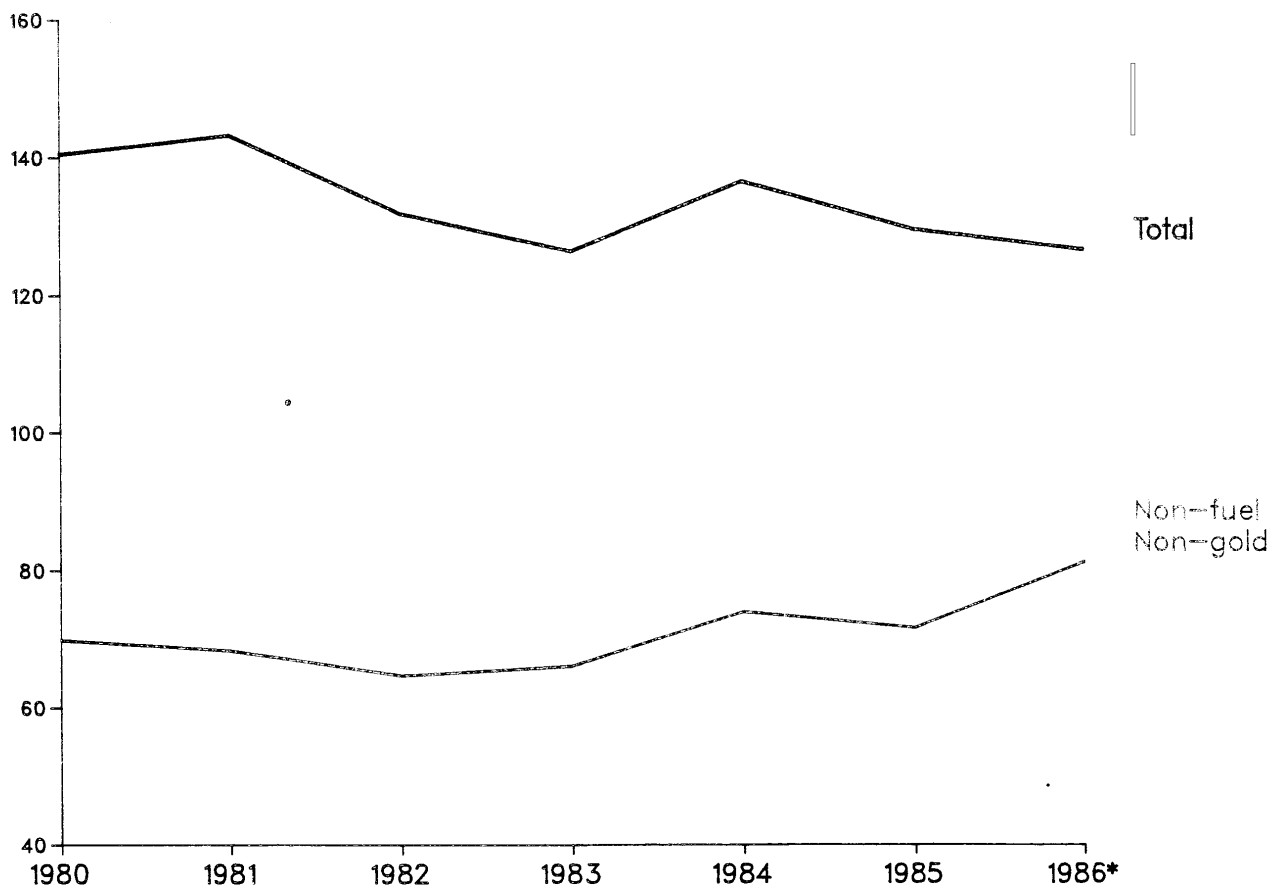


25X1

Page Denied

Figure 1

Japan: Imports
Billion US Dollars



*Estimated

Figure 2

Japan: Import Volume*

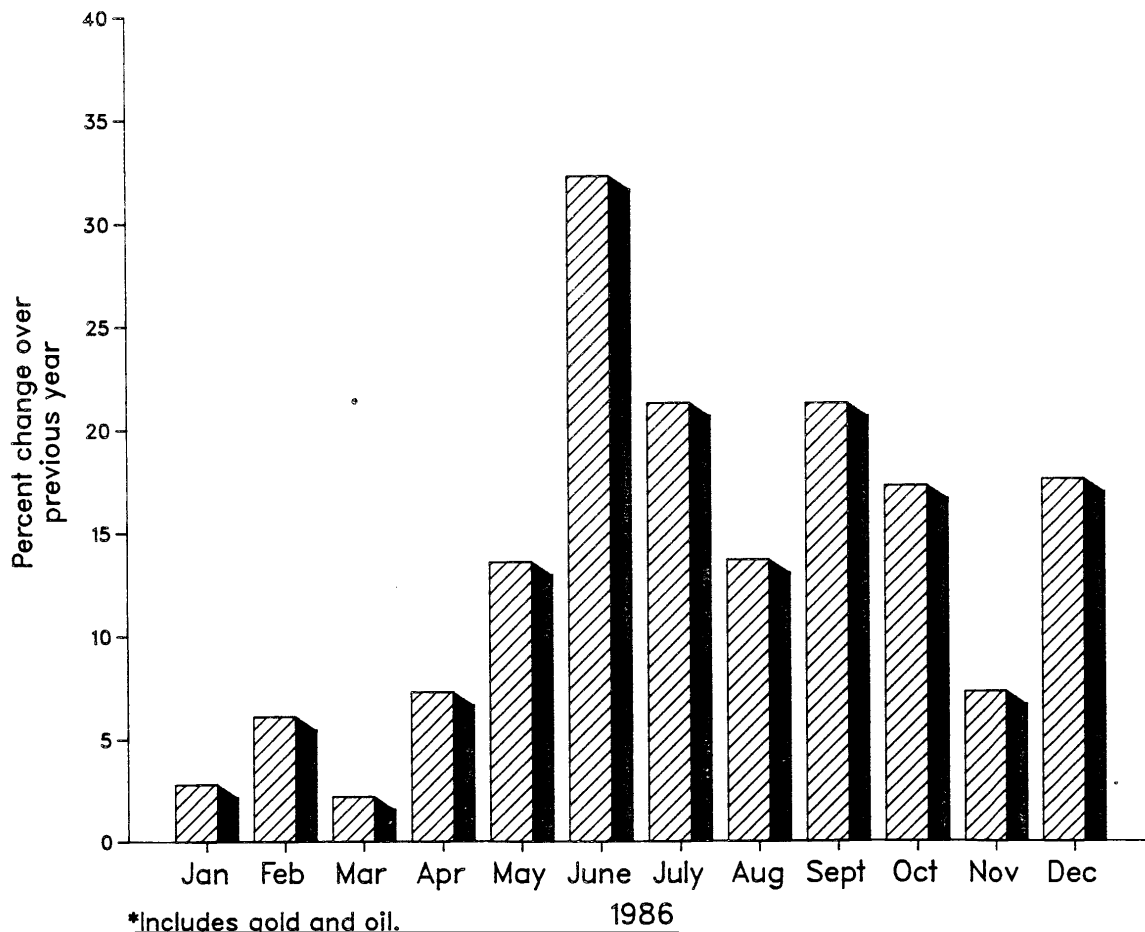
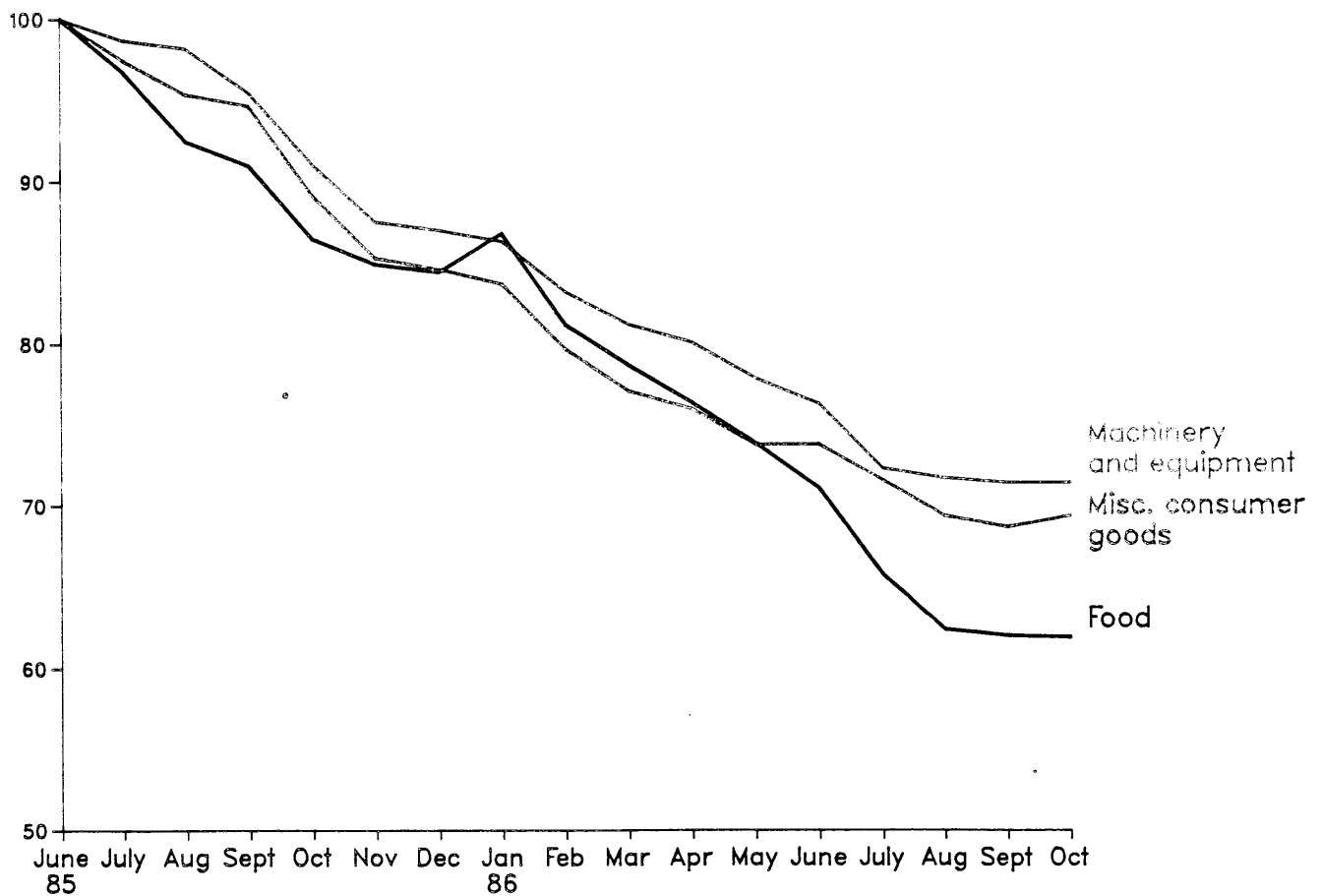


Figure 3

Japan: Yen Import Prices*
June 1985=100



*Yen prices paid by



25X1

SUBJECT: Japanese Imports: Sluggish Response to Yen Appreciation



25X1

Distribution:

1 - Joseph Massey, USTR



25X1

- 1 - Donald Gregg, Office of the Vice President
- 1 - Thomas Hubbard, Department of State
- 1 - William Brooks, Department of State
- 1 - Chuck Kartman, Department of State
- 1 - Marshall Casse, Department of State
- 1 - Robert Reis, Department of State
- 1 - Nicholas Riegg, Department of State
- 1 - Allen Wallis, Department of State
- 1 - James Kelly, Special Assistant to the President, NSC
- 1 - Cdr. (Ret.) James Auer, DOD/ISA/EAP



25X1

- 1 - Stephen Danzansky, National Security Council
- 1 - Louis Pugliarisi, National Security Council
- 1 - Bruce Smart, Department of Commerce
- 1 - H.P. Goldfield, Department of Commerce
- 1 - Byron Jackson, Department of Commerce
- 1 - Allen Lenz, Department of Commerce
- 1 - Mel Searles, Department of Commerce
- 1 - Maureen Smith, Department of Commerce
- 1 - David Mulford, Department of Treasury
- 1 - Robert Cornell, Department of Treasury
- 1 - Doug Mulholland, Department of Treasury
- 1 - Robert Fauver, Department of Treasury
- 1 - Richard Woodworth, Department of Treasury



25X1

- 1 - David Germany, Council of Economic Advisers

Central Intelligence Agency

- 1 - Director, DCI/DDCI Executive Staff
- 1 - NIO/EA
- 1 - NIO/Economics
- 1 - C/EA
- 1 - OGI/IIC/PI
- 1 - OEA/NEA/Korea Branch
- 1 - OEA/NEA/STI Branch
- 1 - OEA/NEA Division
- 1 - OEA/China Division
- 1 - OEA/SEA Division
- 1 - D/OEA
- 1 - C/Production/OEA
- 1 - FBIS/NEAD
- 1 - DDI

25X1



25X1

[Redacted]

25X1

- 1 - Senior Review Panel
- 1 - PDB Staff
- 1 - C/PES
- 1 - CPAS/ILS
- 5 - CPAS/IMC/CB
- 1 - Branch
- 1 - LDA
- 1 - NIC/AG
- 1 - DDO/EA Division
- 1 - DDO/EA [Redacted]
- 1 - [Redacted]
- 2 - Author
- 1 - Chrono
- DDI/OEA/NEA/Japan [Redacted]

25X1
25X1

10 February 1987

25X1

[Redacted]

25X1